

the research. In 1982, B performs all of the research, and A makes full payment of \$300x under the contract. Accordingly, during the taxable year 1982, \$195x (65 percent of the payment of \$300x) constitutes a contract research expense of A.

*Example 2.* The facts are the same as in example (1), except that B performs 50 percent of the research in 1983. Of the \$195x of contract research expense paid in 1982, paragraph (e)(4) of this section provides that \$97.5x (50 percent of \$195x) is a contract research expense for 1982 and the remaining \$97.5x is contract research expense for 1983.

*Example 3.* The facts are the same as in example (1), except that instead of calling for a flat payment of \$300x, the contract requires A to reimburse B for all expenses plus pay B \$100x. B incurs expenses attributable to the research as follows:

Labor .....	\$90x
Supplies .....	20x
Depreciation on equipment .....	50x
Overhead .....	40x
Total .....	200x

Under this agreement A pays B \$300x during 1982. Accordingly, during taxable year 1982, \$195x (65 percent of \$300x) of the payment constitutes a contract research expense of A.

*Example 4.* The facts are the same as in example (3), except that A agrees to reimburse B for all expenses and agrees to pay B an additional amount of \$100x, but the additional \$100x is payable only if the research is successful. The research is successful and A pays B \$300x during 1982. Paragraph (e)(2) of this section provides that the contingent portion of the payment is not an expense incurred for the performance of qualified research. Thus, for taxable year 1982, \$130x (65 percent of the payment of \$200x) constitutes a contract research expense of A.

*Example 5.* C conducts in-house qualified research in carrying on a trade or business. In addition, C pays D Corporation, a provider of computer services, \$100x to develop software to be used in analyzing the results C derives from its research. Because the software services, if performed by an employee of C, would constitute qualified services, \$65x of the \$100x constitutes a contract research expense of C.

*Example 6.* C conducts in-house qualified research in carrying on C's trade or business. In addition, C contracts with E Corporation, a provider of temporary secretarial services, for the services of a secretary for a week. The secretary spends the entire week typing reports describing laboratory results derived from C's qualified research. C pays E \$400 for the secretarial service, none of which constitutes wages within the meaning of section 41(b)(2)(D). These services, if performed by employees of C, would constitute qualified services within the meaning of section

41(b)(2)(B). Thus, pursuant to paragraph (e)(1) of this section, \$260 (65 percent of \$400) constitutes a contract research expense of C.

*Example 7.* C conducts in-house qualified research in carrying on C's trade or business. In addition, C pays F, an outside accountant, \$100x to keep C's books and records pertaining to the research project. The activity carried on by the accountant does not constitute qualified research as defined in section 41(d). The services performed by the accountant, if performed by an employee of C, would not constitute qualified services (as defined in section 41(b)(2)(B)). Thus, under paragraph (e)(1) of this section, no portion of the \$100x constitutes a contract research expense.

[T.D. 8251, 54 FR 21204, May 17, 1989, as amended by T.D. 8930, 65 FR 287, Jan. 3, 2001]

**§ 1.41-3 Base amount for taxable years beginning on or after January 3, 2001.**

(a) *New taxpayers.* If, with respect to any credit year, the taxpayer has not been in existence for any previous taxable year, the average annual gross receipts of the taxpayer for the four taxable years preceding the credit year shall be zero. If, with respect to any credit year, the taxpayer has been in existence for at least one previous taxable year, but has not been in existence for four taxable years preceding the taxable year, then the average annual gross receipts of the taxpayer for the four taxable years preceding the credit year shall be the average annual gross receipts for the number of taxable years preceding the credit year for which the taxpayer has been in existence.

(b) *Special rules for short taxable years—(1) Short credit year.* If a credit year is a short taxable year, then the base amount determined under section 41(c)(1) (but not section 41(c)(2)) shall be modified by multiplying that amount by the number of months in the short taxable year and dividing the result by 12.

(2) *Short taxable year preceding credit year.* If one or more of the four taxable years preceding the credit year is a short taxable year, then the gross receipts for such year are deemed to be equal to the gross receipts actually derived in that year multiplied by 12 and divided by the number of months in that year.

(3) *Short taxable year in determining fixed-base percentage.* No adjustment shall be made on account of a short taxable year to the computation of a taxpayer's fixed-base percentage.

(c) *Definition of gross receipts*—(1) *In general.* For purposes of section 41, gross receipts means the total amount, as determined under the taxpayer's method of accounting, derived by the taxpayer from all its activities and from all sources (e.g., revenues derived from the sale of inventory before reduction for cost of goods sold).

(2) *Amounts excluded.* For purposes of this paragraph (c), gross receipts do not include amounts representing—

- (i) Returns or allowances;
- (ii) Receipts from the sale or exchange of capital assets, as defined in section 1221;
- (iii) Repayments of loans or similar instruments (e.g., a repayment of the principal amount of a loan held by a commercial lender);

(iv) Receipts from a sale or exchange not in the ordinary course of business, such as the sale of an entire trade or business or the sale of property used in a trade or business as defined under section 1221(2);

(v) Amounts received with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority; and

(vi) Amounts received by a taxpayer in a taxable year that precedes the first taxable year in which the taxpayer derives more than \$25,000 in gross receipts other than investment income. For purposes of this paragraph (c)(2)(vi), investment income is interest or distributions with respect to stock (other than the stock of a 20-percent owned corporation as defined in section 243(c)(2)).

(3) *Foreign corporations.* For purposes of section 41, in the case of a foreign corporation, gross receipts include only gross receipts that are effectively connected with the conduct of a trade or business within the United States, the Commonwealth of Puerto Rico, or other possessions of the United States. See section 864(c) and applicable regu-

lations thereunder for the definition of effectively connected income.

(d) *Consistency requirement*—(1) *In general.* In computing the credit for increasing research activities for taxable years beginning after December 31, 1989, qualified research expenses and gross receipts taken into account in computing a taxpayer's fixed-base percentage and a taxpayer's base amount must be determined on a basis consistent with the definition of qualified research expenses and gross receipts for the credit year, without regard to the law in effect for the taxable years taken into account in computing the fixed-base percentage or the base amount. This consistency requirement applies even if the period for filing a claim for credit or refund has expired for any taxable year taken into account in computing the fixed-base percentage or the base amount.

(2) *Illustrations.* The following examples illustrate the application of the consistency rule of paragraph (d)(1) of this section:

*Example 1.* (i) X, an accrual method taxpayer using the calendar year as its taxable year, incurs qualified research expenses in 2001. X wants to compute its research credit under section 41 for the tax year ending December 31, 2001. As part of the computation, X must determine its fixed-base percentage, which depends in part on X's qualified research expenses incurred during the fixed-base period, the taxable years beginning after December 31, 1983, and before January 1, 1989.

(ii) During the fixed-base period, X reported the following amounts as qualified research expenses on its Form 6765:

1984 .....	\$100x
1985 .....	120x
1986 .....	150x
1987 .....	180x
1988 .....	170x
<b>Total .....</b>	<b>720x</b>

(iii) For the taxable years ending December 31, 1984, and December 31, 1985, X based the amounts reported as qualified research expenses on the definition of qualified research in effect for those taxable years. The definition of qualified research changed for taxable years beginning after December 31, 1985. If X used the definition of qualified research applicable to its taxable year ending December 31, 2001, the credit year, its qualified research expenses for the taxable years ending December 31, 1984, and December 31,

1985, would be reduced to \$ 80x and \$ 100x, respectively. Under the consistency rule in section 41(c)(5) and paragraph (d)(1) of this section, to compute the research credit for the tax year ending December 31, 2001, X must reduce its qualified research expenses for 1984 and 1985 to reflect the change in the definition of qualified research for taxable years beginning after December 31, 1985. Thus, X's total qualified research expenses for the fixed-base period (1984-1988) to be used in computing the fixed-base percentage is  $\$80 + 100 + 150 + 180 + 170 = \$680x$ .

*Example 2.* The facts are the same as in *Example 1*, except that, in computing its qualified research expenses for the taxable year ending December 31, 2001, X claimed that a certain type of expenditure incurred in 2001 was a qualified research expense. X's claim reflected a change in X's position, because X had not previously claimed that similar expenditures were qualified research expenses. The consistency rule requires X to adjust its qualified research expenses in computing the fixed-base percentage to include any similar expenditures not treated as qualified research expenses during the fixed-base period, regardless of whether the period for filing a claim for credit or refund has expired for any year taken into account in computing the fixed-base percentage.

(e) *Effective date.* The rules in paragraphs (c) and (d) of this section are applicable for taxable years beginning on or after the date final regulations are published in the FEDERAL REGISTER.

[T.D. 8930, 66 FR 289, Jan. 3, 2001]

**§ 1.41-4 Qualified research for expenditures paid or incurred on or after January 3, 2001.**

(a) *Qualified research—(1) General rule.* Research activities related to the development or improvement of a business component constitute qualified research only if the research activities meet all of the requirements of section 41(d)(1) and this section, and are not otherwise excluded under section 41(d)(3)(B) or (d)(4), or this section.

(2) *Requirements of section 41(d)(1).* Research constitutes qualified research only if it is research—

(i) With respect to which expenditures may be treated as expenses under section 174, see § 1.174-2;

(ii) That is undertaken for the purpose of discovering information that is technological in nature, and the application of which is intended to be useful in the development of a new or im-

proved business component of the taxpayer; and

(iii) Substantially all of the activities of which constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability or quality.

For certain recordkeeping requirements, see paragraph (d) of this section.

(3) *Undertaken for the purpose of discovering information—(i) In general.* For purposes of section 41(d) and this section, research is undertaken for the purpose of discovering information only if it is undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering. A determination that research is undertaken for the purpose of discovering information does not require that the taxpayer succeed in obtaining the knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering, nor does it require that the advance sought be more than evolutionary. However, research is not undertaken for the purpose of discovering information merely because an expenditure may be treated as an expense under section 174.

(ii) *Common knowledge.* Common knowledge of skilled professionals in a particular field of science or engineering means information that should be known to skilled professionals had they performed, before the research in question is undertaken, a reasonable investigation of the existing level of information in the particular field of science or engineering. Thus, knowledge may, in certain circumstances, exceed, expand, or refine the common knowledge of skilled professionals in a particular field of science or engineering even though such knowledge has previously been obtained by other persons. For example, trade secrets generally are not within the common knowledge of skilled professionals in a particular field of science or engineering because they are not reasonably available to skilled professionals not employed, hired, or licensed by the owner of such trade secrets.